

Filing Status for Timber Sales

Tennessee Department of Agriculture, Division of Forestry

How you report a timber sale and whether you get capital gains treatment depends on whether you qualify as a hobbyist, investor, passive manager or active manager.

Hobbyists do not own their land primarily to produce a profit from timber. They must report any timber sales as ordinary income and can deduct sale expenses from sale proceeds in the year of sale.

To qualify as an investor or business, the landowner must demonstrate a profit motive for holding land. This can be done by having a current forest management plan, projecting future profits, participating in activities related to timber growth and sales, etc.

Investors have a profit motive for owning timber, but they sell timber infrequently, do not participate actively in timber management, and do not own their timber as part of a trade or business. Many absentee landowners fall into this category.

Investors can get capital gains treatment by selling timber using any method. Investors can deduct expenses against any source of income, above a 2% floor. All deductions below this 2% threshold are lost. Alternatively, investors can capitalize all expenses and recover them when the timber is sold. Investors can deduct property taxes from income from any source, and can deduct interest from investment income. Investors, like businesses, can deduct casualty losses from any source of income. Investors don't pay self-employment tax on cost share payments, while businesses do.

Persons are considered "in the timber business" if they are more active in their management than investors, if they sell timber fairly regularly, or if they own the timber as part of a trade or business. Growing and harvesting timber, as in a Tree Farm, can qualify as being in the timber business.

To get capital gains treatment, businesses must sell timber under the provisions of Section 631(a) or 631(b), which means they cannot sell by lump sum and still claim capital gains.

"Passive" managers are more involved in managing than are investors, but less involved than active managers. Passive managers can deduct all expenses, but only against passive income. However, they can carry forward unused

deductions indefinitely and apply them against future timber sale income.

"Active" manager status is generally the most advantageous, since active managers can deduct expenses against income from any source.

The IRS "passive loss rules" are the standard by used to determine whether you qualify as an active or passive manager. To qualify, your participation must be "regular, continuous and substantial" as defined by the following tests:

1. you spent more than 500 hours per year managing the business, or
2. you conducted substantially all the management activities related to the business, or
3. you participated for more than 100 hours and no one participated more, or
4. your participation in "significant activities" exceeded 500 hours (a significant activity is one where your participation exceeds 100 hours but doesn't in itself meet a material participation test).
5. you materially participated (were considered an "active" manager) in 5 of the last 10 years, or
6. all the facts and circumstances indicate that your participation was regular, continual and substantial (this test should not be relied upon)

As a general guide, if you spend less than 100 hours per year managing your forest and if you hire a manager, you will not qualify for active status.

(Note: retired or disabled persons may be exempt from the passive loss rule under Section 2032(a) if their land qualifies as a farm business; they need only be involved in making major decisions.)

Those who qualify as active or passive business managers must sell in accordance with IRS Code Section 631(a) or 631(b) in order to qualify for capital gains. (See Forestry Information Sheet "Timber Sales Qualifying for Capital Gains Treatment").

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